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NebFact



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Tax Considerations in Selling Farm Property

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There are several ways of selling business and personal assets. Each method will have a different impact on both the seller's and the buyer's tax liability, and can be used to increase the buyer's ability to purchase or transfer assets prior to death. Therefore, the decision of which method to use should depend on the retirement and estate planning objectives of the owner.

The general strategy for selling farm property from an estate planning viewpoint is to sell high basis property and to pass on low basis property through your estate. This reduces the amount of capital gains taxes which the seller will have to pay. At the same time, property passed on to heirs through inheritance typically receives a "stepped-up" basis equal to the fair market value of the property on the date of the decedent's death.

For non-depreciable assets, basis is the purchase price plus any improvements; for depreciable assets, it is the purchase price plus any improvements less depreciation already taken. Low (high) basis property is property which has a low (high) basis relative to its fair market value. For more information on basis, see NebFact 93-144, *Determining Property Basis*.

This NebFact discusses various ways of selling business and personal assets from an estate planning viewpoint. The types of sales presented here are 1) the cash sale, 2) the installment sale and 3) the tax free exchange. Competent legal and financial counseling is important in order to implement the alternatives.

Cash Sales

Bill and Sue own a 640-acre farm. At retirement they want to move off of the farm and into town. They plan to retire on social security and the income they receive from the sale of their farm. A buyer is found who wants the farm, including all of its buildings and residence. The selling price on the residence is established and a separate one on the business assets of the farm is established. Upon selling the farm and residence, they buy another house in town. They will owe a capital gains tax on the capital gain realized from selling the farm but they have avoided paying a capital gain on the house by purchasing

another one. Table I shows the calculations for the cash sale.

Table I. Tax consequences to Bill and Sue for the cash sale of their farm.

	<i>Selling Price</i>	<i>Basis</i>	<i>Capital Gain</i>	<i>Capital Gains Tax Liability (28% tax)</i>
Residence	\$50,000	\$30,000	\$20,000	\$5,600 ^a
Land	500,000	200,000	300,000	\$84,000

^aThis tax liability is not incurred if another house of equal or greater value is purchased within two years of sale or if the sellers are over 55 years old and exercise their right to a once in a lifetime \$125,000 capital gains exclusion on the sale of a house.

A cash sale is the simplest way to sell assets. With a cash sale, the seller simply sells, or transfers, ownership rights of the property to the buyer. The seller does not finance the sale but receives payment in full at the time of sale.

The capital gain on a cash sale is the selling price minus the basis. On business assets a tax must be paid on the capital gain. Selling low basis property will likely result in a large capital gains tax liability. If part of an estate is going to be sold and part passed on to the heirs after death, it would be wise to consider selling high basis property and passing on the low basis property through inheritance. This method should minimize the capital gain tax paid.

The sale of a personal residence is subject to different capital gains tax consequences. The capital gain realized from the sale of a personal residence can be postponed by reinvesting in a new home of equal or greater value within two years of the sale. After age 55, most home owners have a once in a lifetime exclusion of \$125,000 in capital gain on their personal residence. This allows persons 55 and older to sell their residence without having to pay the capital gains tax on the first \$125,000 of capital gains.

If the personal residence is part of a business, as in a family farm, the sales contract should specify the selling price of the business property and of the personal residence. Each piece of property, the residence and the business, would have its own basis and capital gain or loss for tax purposes when sold.

Installment Sale

Bill and Sue own a 640-acre farm. At retirement they want to move off of the farm and into town. They plan to retire on social security and the income they receive from the sale of their farm. They are concerned about the large capital gains tax liability they will have when they sell the farm. Their son wants the farm but currently is not financially able to get the down payment and wants a lower interest rate than the bank is offering. Bill and Sue agree to sell the farm to their son for equal annual principal payments and a 6 percent interest charge on the unpaid balance. Now their capital gains tax liability is spread out over the life of the finance agreement they have written with their son. Part of the payment they receive every year will be considered capital gain and part will be considered interest income. Table II shows the calculations for this installment sale of the farm.

Table II. Tax consequences to bill and Sue for the installment sale of their farm.

	<i>Selling Price</i>	<i>Basis</i>	<i>Capital Gain</i>	<i>Annual Realized Capital Gain</i>	<i>Capital Gains Tax Liability (28% tax^c)</i>
Residence	\$50,000	\$30,000	\$20,000	NA	\$5,600 ^a
Land	500,000	200,000	300,000	15,000 ^b	\$4,200

^aThis tax liability is not incurred if another house of equal or greater value is purchased within two years or if the sellers are over 55 years old and exercise their right to a once in a lifetime \$125,000 capital gains exclusion on the sale of a house.

^bAssumes 20 equal annual principal payments of \$25,000 for the land.

^cSpreading the capital gain over several years could bring a person into a lower tax bracket.

The installment sale is used to delay paying a large lump sum capital gains tax by spreading the gain out over several years. It may also result in the seller being in a lower tax bracket. Installment sales can provide the buyer with better credit terms than a mortgage from a lending institution. An installment sale occurs when the seller finances the sale of his or her assets. The IRS assumes an installment sale if 1) the seller does not receive full payment in the year an asset is sold and 2) the sale results in a capital gain. Property sold at a loss does not qualify for installment treatment. Depreciation recapture income does not qualify for installment sale treatment. A seller may elect not to have a sale considered an installment sale and pay any tax due immediately.

A "profit percentage" is used to figure the percentage of principal payment that will be taxed as gain in a given year. The profit percentage is the gross profit (generally the capital gain) divided by the price received for the property. In Bill and Sue's case the percentage profit is 60 percent (\$300,000 ÷ \$500,000 = .60). Therefore, capital gains tax would be charged on \$15,000 per year (\$25,000 principal payment x .60).

If an installment sale involves depreciable property such as equipment, machinery and purchased breeding stock, the sellers are required to report in the year of sale any income that is considered recaptured depreciation even if the payment will not be received until a year later.

Interest received is ordinary income to the seller and is taxed as such. A minimum interest rate of 6 percent can be used in sales to family members for land up to \$500,000 of value. For sales to unrelated parties, the interest charge must be at least 9 percent or the Applicable Federal Rate, published monthly by the IRS in the Internal Revenue Bulletin. Higher interest rates can be charged by the seller, if the buyer and seller agree.

If the buyer is related to the seller and disposes of installment sale property by sale or gift, within two years of initially buying the property, the seller will pay tax on the remaining capital gain resulting from the original sale. A related person includes a spouse, child, grandchild, parent, grandparent, brother, or sister. A controlled corporation, partnership, trust or estate may also be considered a related person.

Under certain conditions, installment sales to related individuals are not permitted. For example, the installment method cannot be used for sales of depreciable property between related persons.

If the contract purchaser inherits the full remaining contract, the remaining capital gain taxes must be paid in full at estate settlement time. Additionally, the remaining balance of the contract at the time of death does not receive a stepped-up basis nor does it qualify for special-use

valuation, as is normally the case for inherited assets. If property were sold to unrelated persons, at the time of the seller's death, the heirs of the seller's estate are taxed in the same way as the seller would have been if the seller had lived to receive the payments.

The Tax Free Exchange

The tax free exchange can be useful when a person has a low basis problem or depreciation recapture problems with buildings. A tax free exchange is also called a like-kind exchange because it must involve the exchange of like property. Real estate must be traded for real estate; personal property for personal property. Inventory cannot be traded in a tax free exchange.

If a gain or loss occurs on a tax free exchange, it is not included in income for tax purposes until the property received is sold or disposed of.

Only business or investment property held for productive use is eligible for a tax free exchange. Personal residences must be divided from the property used in a tax free exchange. Property held primarily for sale also does not qualify for a tax free exchange. To qualify as a tax free exchange the specific property to be exchanged must be designated in the contract (e.g. the SW quarter of section 20 in township xx, rather than a quarter of land to be identified later).

If one person receives money or unlike property in a tax free exchange, it is considered a partially non-taxable exchange. The persons are taxed on the cash and unlike portion of the gain they realized. The gain would be limited to the amount of money and the fair market value of unlike property given in trade.

If property received in a tax free exchange between related persons is disposed of (sold, given away, etc) within two years of the initial tax free exchange then the exchange is disqualified from being a tax free exchange. Exceptions to this mandatory two year holding period are if 1) the disposition was due to the death of either related party or 2) an involuntary disposition such as the property being stolen, destroyed or condemned.

Sales of Inventory — Crops, Livestock and Supplies.

When crops are sold by a cash basis taxpayer the transaction is fully taxable at the time of sale since the expenses of raising crops have already been deducted. When livestock is sold receipts minus the cost of livestock purchased are fully taxable at the time of sale.

Passing inventories through an estate may allow the inventory to receive a stepped-up basis so that the sale of it by heirs would be tax free, except for any gain accrued since the decedent's death. See NebFact 93-145, *Special-Use and Alternate Valuation of Estate Property*, for more information.

Additional References

IRS Publication 537, *Installment Sales*.

IRS Publication 225, *Farmers Tax Guide*, Chapter 12.

IRS Publication 544, *Sales and Other Dispositions of Assets*, Chapter 1.

The information contained in this NebFact is for educational purposes only. Tax is complicated and the information presented here has necessarily been simplified. See a tax consultant for specific questions.

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